

Back to the end of 2009, the Manchester United was seeing a growing turnover and a decreasing senior debt level. While MU has operated well financially, its ultimate parent company, Red Football Joint Venture, which is held by the Glazer family, was suffering a growth of debt of xx million due to the rolled-up of the PIK loans. Manchester United was faced with several financing alternatives other than bond issue: using internal financing available, or resorting to other sources of external financing, such as bank loan and public offering. Given the specific financing goals, we will apply the pecking order theory to analyzing the feasibility of different financing alternatives.

### 1. Financing goals

The financing goals for MU is to generate enough capital to pay off senior bank loan and start the repayment of PIK loan, without diluting ownership or losing control of the club.

As MU is held by the Glazer-controlled Red Football Ltd, it acts in line with the interest of its parent company. What bothers the Red Football most is the substantial rolled-up of the 14.25% PIK interest, which causes the loans to grow from £138 million in 2006 to £202 million at the beginning of 2010. Furthermore, under the term of loan, if the MU exceeds a ratio of five times of net debt to earnings before interest, tax, depreciation and amortization, the loan rate will increase 2% from August, 2010. As the senior bank lenders have first call on debt clearance, the Red Football could only tackle the PIK debt after the payoff of bank loans. Thus, the major financing goal is to wipe out the bank debt and start repaying the PIK loan.

As the Glazers insist on the private ownership of MU, the financing tool should work without diluting ownership or losing governing control. It's true that given a fat profit, the Glazers would probably give up the ownership. However, we assume that under the current economic situation, there is little chance that the incentive is big enough for the Glazers to give up control.

### 2. Pecking Order Theory

The Pecking Order Theory, developed by Steward C. Myers and Nicolas Majlufin in 1984, states that the firms "prioritize the source of financing according to the Principle of least effort, or of least resistance, preferring to raise equity as a financing means of last resort". Thus, firms prefer retained earning first, and when it is depleted, firms tend to finance first with straight debt, then hybrid securities such as convertible bonds, and finally, equity.

In the case of MU financing, MU is faced with different financing options: generating capital through retained earnings, rolling over debt through straight bank loan, resorting

to private or public placement, etc. Combined with the financial situation and financing goals of MU, these options are of different feasibility.

### 3. Internal finance—Retained Earnings

Firms could raise capital internally by retaining the earnings they generate. The firm does not have to incur large transaction costs and interest payments. Also, the firm would not be influenced by third party or creditworthiness. However, the internal financing is limited in volume and floats with the earning.

MU is generally doing well financially since the Glazers' takeover. Since 2004, the last full year before the takeover, the turnover has risen 64%. In 2009, the club generated total sales of £278 million and an operating profit of £91 million, nearly doubled since 2006 (though this was partly boosted by the high transfer fee of £80 million for Cristiano Ronaldo). The club also manage to cast its net wider, forge deals with Budweiser (the brewer), Betfair (the online bookmaker), and overseas telecoms companies in Nigeria, Saudi Arabia and Indonesia. MU is "cutting and dicing commercial rights in multiple ways", as is said by an industry analyst.

However, most of the turnovers are used to pay the interest on its loans. The interest for the senior bank loans alone last year totalled £41 million, which offset large part of the profit. The interest is one thing, the principal is another. As Manchester United Supporter Trust responded, "The amount of money needed to be repaid overall is hugh...the interest payment is one thing but what about the actual £660 million?" The Glazers may have had good plan of repayment when debt financing the takeover, but their pre recession plan has gone with the wind.

Though internal financing is a preferable option according to the Pecking Order Theory, and allows the Glazers to keep control of MU, it could not generate sufficient profits to cover the existing senior debt in due time. Thus, this financing option is not feasible.

### 4. External finance—bank loan

According to the Pecking Order Theory, if external financing is required, the firm tend to finance first with straight debt. Bank loan is a typical straight debt that does not include any features other than principle and interest payment. Refinancing through bank loan may allow the firm to reduce interest cost by refinancing at a lower rate, to extend payment time, to pay off other debt, to reduce or alter risks, etc. The benefit of bank loan is offset if the bankruptcy costs and transactions cost is high enough to push the interest rate too high.

The UK companies have long relied on bank lending. Before the credit crunch, 9% of the companies raise fund through bond markets while 32% in the form of loans. MU had already rolled over the debt several times since the takeover. It is possible if the economic situation is stable, MU would continue rolling over. However, the credit crunch since 2008 summer has forced MU to abandon the £660 million refinancing deal through bank loan. According to reports, MU talked with a number of banks about a new financing package. However, the credit crunch made MU either getting the loan at an incredibly expensive rate or not getting at all. The soaring cost of bank loan place the traditional refinancing plan on hold.

There are some considerations of not using the bank loan. The bank loan lenders impose strict financial conditions on the firm, such as the money the firm spent and certain performance targets. Using different source of finance would relieve MU of such conditions; however, it may also bring in other protective covenants from other stakeholders.

Another consideration is that using other financing options, such as bond issue, may provide MU greater financial security in the long term. The present senior bank loan is directly linked LIBOR, which means if LIBOR rises, MU would have to make costly repayment. By converting the floating rate debt to a fixed rate debt, MU would enjoy a less risky future.

In all, though bank loan is more preferable than other external financing options according to Pecking Order Theory and by MU, it is not available under the current economic situation.

## 5. External financing—equity

Raising equity is the last resort according to Pecking Order Theory. The equity, either in the form of private placement or public placement, will result in a dilution of ownership, control and earnings. As we assume under the current economic situation, private source of financing would not be a big enough incentive for the Glazers to give up ownership and control, we will not consider the feasibility of private placement.

Going public will provide better access to capital markets and wider investor base, however, equity is much more costly to issue, especially for firms issuing for the first time. The initial public offerings are far riskier and more difficult to price than other financial instruments. Also, equity would trigger large transaction cost and agency costs.

In the case of MU, if Red Football decides to replace all debts with equity, it would lose the ownership unless the Glazers get largest portion of the shares either through debt

or out of their own pocket. This is not a preferable option, since the cost is high and the equity is very likely to be placed at a lower value by investor.

If Red Football makes a mix of debt and equity capital structure, the ownership may be diluted by the Glazers could still have control on MU. However, the cost of equity may end up with an increased hurdle rate. Agency costs would arise due to the conflicts between debt holders and equity holders as the equity holders have incentive to invest suboptimally, that is, either overinvest or underinvest.

The investors may have less incentive to buy due to the high leverage, lack of credit rating and unstable financial history of the firm.

Due to the above reasons, equity financing is not a preferable option either based on the Pecking Ordering Theory, or on MU's financing goals.

In conclusion, we conclude that refinancing through bond issue is the most feasible way.